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Pallas Perspective

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U.S. Debt Downgrade Mostly met with Resilience

On August 1, Fitch Ratings, a credit rating agency, downgraded the credit rating of U.S. Government debt one notch, from 'AAA' to 'AA+.' The rating agency had warned that it might make this step several months ago during the U.S. debt ceiling standoff.

The timing of this credit downgrade is unusual given the lack of near-term concerns with the debt ceiling and the recent strong numbers around U.S. economic growth. The rationale given was longer-term concern about the plan for managing U.S. Government debt in a higher interest rate environment. As well as the ever-escalating demands to support core programs such as social security and healthcare.

The Fitch Ratings action echoes the S&P's decision in August 2011 to downgrade the U.S. to 'AA+' amid a debt ceiling standoff. At that time, U.S. stocks initially sold off but recovered very quickly, and U.S. Treasury bonds rallied on a flight-to-quality trade. In this week's markets, Treasury yields were initially unchanged on the downgrade announcement but then ticked higher later in the session sending fixed-income markets down. Equity markets also dropped following the downgrade. However, the actual cause of the market reaction is unclear as it came alongside headlines on larger-than-expected upcoming Treasury actions and continued strength in the U.S. labor market and recent new highs in the equity market.

This latest action by Fitch is likely to increase longer-term concerns about the demand for Treasury securities and weigh on the longer-term end of the bond market. The benchmark 10-year treasury is back to levels that have not been seen in the past 15 years and are on par with the peak seen during last fall.

10-Year Treasury Yield

Source: FactSet

The near-term market and investment implications for higher rates will be headwinds. A run higher in the bond markets will likely put pressure on fixed income returns which move inversely with yields. For the equity markets, higher rates may limit further multiple expansion which has been the primary driver of returns year-to-date. Offsetting the investment market headwinds will be prospects of lower inflation, continued resilience of the U.S. economy, and relative safety of U.S. investment on the world stage.

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